HERBALIFE LTD.
Form 10-Q
May 02, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2011

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________.

Commission file number: 1-32381

HERBALIFE LTD.

(Exact name of registrant as specified in its charter)

Cayman Islands	**98-0377871**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

P.O. Box 309GT
Ugland House, South Church Street
Grand Cayman, Cayman Islands
(Address of principal executive offices) (Zip code)
(213) 745-0500
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Number of shares of registrant s common shares outstanding as of April 27, 2011 was 59,618,612

HERBALIFE LTD.

PART I. FINANCIAL INFORMATION

PART II. OTHER INFORMATION

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PART I. FINANCIAL INFORMATION

Item 1. ***FINANCIAL STATEMENTS***

HERBALIFE LTD.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	March 31, 2011	December 31, 2010
	(In thousands, except share amounts)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 260,766	$ 190,550
Receivables, net of allowance for doubtful accounts of $2,895 (2011) and $3,202 (2010)	107,893	85,612
Inventories	184,321	182,467
Prepaid expenses and other current assets	110,400	93,963
Deferred income taxes	42,355	42,994
Total current assets	705,735	595,586
Property, at cost, net of accumulated depreciation and amortization of $185,928 (2011) and $166,912 (2010)	187,733	177,427
Deferred compensation plan assets	18,732	18,536
Deferred financing costs, net of accumulated amortization of $65 (2011) and $2,279 (2010)	5,451	998
Other assets	26,639	25,880
Marketing related intangibles and other intangible assets, net	310,815	310,894
Goodwill	102,899	102,899
Total assets	$ 1,358,004	$ 1,232,220
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 53,725	$ 43,784
Royalty overrides	173,076	162,141
Accrued compensation	52,540	69,376
Accrued expenses	138,523	141,867
Current portion of long-term debt	1,753	3,120
Advance sales deposits	56,928	35,145
Income taxes payable	18,340	15,383
Total current liabilities	494,885	470,816
NON-CURRENT LIABILITIES:		
Long-term debt, net of current portion	181,188	175,046
Deferred compensation plan liability	23,197	20,167
Deferred income taxes	55,220	55,572
Other non-current liabilities	23,216	23,407

Total liabilities		777,706		745,008
CONTINGENCIES				
SHAREHOLDERS EQUITY:				
Common shares, $0.002 par value, 500.0 million shares authorized, 59.4 million (2011) and 58.9 million (2010) shares outstanding		119		118
Paid-in-capital in excess of par value		262,617		257,375
Accumulated other comprehensive loss		(12,074)		(27,285)
Retained earnings		329,636		257,004
Total shareholders equity		580,298		487,212
Total liabilities and shareholders equity	$	1,358,004	$	1,232,220

See the accompanying notes to unaudited condensed consolidated financial statements.

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HERBALIFE LTD.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended March 31, 2011	March 31, 2010
	(In thousands, except per share)	
Product sales	$ 676,789	$ 527,222
Shipping & handling revenues	118,307	91,411
Net sales	795,096	618,633
Cost of sales	162,793	140,472
Gross profit	632,303	478,161
Royalty overrides	264,377	207,319
Selling, general & administrative expenses	244,526	206,883
Operating income	123,400	63,959
Interest expense, net	2,648	1,953
Income before income taxes	120,752	62,006
Income taxes	33,184	10,135
NET INCOME	$ 87,568	$ 51,871
Earnings per share:		
Basic	$ 1.48	$ 0.86
Diluted	$ 1.41	$ 0.83
Weighted average shares outstanding:		
Basic	59,103	60,160
Diluted	61,908	62,672
Dividends declared per share	$ 0.25	$ 0.20

See the accompanying notes to unaudited condensed consolidated financial statements.

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HERBALIFE LTD.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended	
	March 31, 2011	March 31, 2010
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 87,568	$ 51,871
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	18,562	17,262
(Excess) Deficiency in tax benefits from share-based payment arrangements	(6,794)	(2,606)
Share-based compensation expenses	5,604	5,295
Amortization of discount and deferred financing costs	149	124
Deferred income taxes	921	(13,671)
Unrealized foreign exchange transaction (gain) loss	1,383	(2,608)
Write-off of deferred financing costs	914	
Foreign exchange loss from adoption of highly inflationary accounting in Venezuela		15,131
Other	751	1,078
Changes in operating assets and liabilities:		
Receivables	(20,493)	(12,048)
Inventories	4,184	474
Prepaid expenses and other current assets	(13,582)	(4,357)
Other assets	(251)	(71)
Accounts payable	8,861	19,311
Royalty overrides	7,340	(7,081)
Accrued expenses and accrued compensation	(21,122)	(14,022)
Advance sales deposits	20,998	26,741
Income taxes payable	9,494	5,566
Deferred compensation plan liability	3,030	1,044
NET CASH PROVIDED BY OPERATING ACTIVITIES	107,517	87,433
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property	(28,325)	(11,623)
Proceeds from sale of property	2	3
Deferred compensation plan assets	(197)	(79)
NET CASH USED IN INVESTING ACTIVITIES	(28,520)	(11,699)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid	(14,819)	(12,065)
Borrowings from long-term debt	289,700	102,000
Principal payments on long-term debt	(284,924)	(104,951)
Deferred financing costs	(5,516)	
Share repurchases	(8,965)	(28,010)
Excess (Deficiency in) tax benefits from share-based payment arrangements	6,794	2,606
	1,689	1,888

Proceeds from exercise of stock options and sale of stock under employee stock purchase plan				
NET CASH USED IN FINANCING ACTIVITIES		(16,041)		(38,532)
EFFECT OF EXCHANGE RATE CHANGES ON CASH		7,260		(22,732)
NET CHANGE IN CASH AND CASH EQUIVALENTS		70,216		14,470
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		190,550		150,801
CASH AND CASH EQUIVALENTS, END OF PERIOD	$	260,766	$	165,271
CASH PAID DURING THE PERIOD				
Interest paid	$	2,093	$	2,691
Income taxes paid	$	21,874	$	13,430

See the accompanying notes to unaudited condensed consolidated financial statements.

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HERBALIFE LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization

Herbalife Ltd., a Cayman Islands exempt limited liability company, or Herbalife, was incorporated on April 4, 2002. Herbalife Ltd. (and together with its subsidiaries, the Company) is a leading global network marketing company that sells weight management, nutritional supplements, energy, sports & fitness products and personal care products through a network of approximately 2.3 million independent distributors, except in China, where the Company currently sells its products through retail stores, sales representatives, sales employees and licensed business providers. The Company reports revenue in six geographic regions: North America, which consists of the U.S., Canada and Jamaica; Mexico; South and Central America; EMEA, which consists of Europe, the Middle East and Africa; Asia Pacific (excluding China) which consists of Asia, New Zealand and Australia; and China.

2. Significant Accounting Policies

Basis of Presentation

The unaudited interim financial information of the Company has been prepared in accordance with Article 10 of the Securities and Exchange Commission s, or the SEC, Regulation S-X. Accordingly, it does not include all of the information required by generally accepted accounting principles in the U.S., or U.S. GAAP, for complete financial statements. The condensed consolidated balance sheet at December 31, 2010 was derived from the audited financial statements at that date and does not include all the disclosures required by U.S. GAAP. The Company s unaudited condensed consolidated financial statements as of March 31, 2011, and for the three months ended March 31, 2011 and 2010, include Herbalife and all of its direct and indirect subsidiaries. In the opinion of management, the accompanying financial information contains all adjustments, consisting of normal recurring adjustments, necessary to present fairly the Company s unaudited condensed consolidated financial statements as of March 31, 2011, and for the three months ended March 31, 2011 and 2010. These unaudited condensed consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2010, or the 2010 10-K. Operating results for the three months ended March 31, 2011, are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

Venezuela

In February 2011, Herbalife Venezuela purchased U.S. dollar denominated bonds with a face value of $20 million U.S. dollars in a bond offering from Petróleos de Venezuela, S.A., a Venezuelan state-owned petroleum company, for 86 million Bolivars and then immediately sold the bonds for $15 million U.S. dollars, resulting in an average effective conversion rate of 5.7 Bolivars per U.S. dollar. The 86 million Bolivars were previously remeasured at the regulated system rate, or SITME rate, of 5.3 Bolivars per U.S. dollar and recorded as cash and cash equivalents of $16.3 million on the Company s consolidated balance sheet at December 31, 2010. This Bolivar to U.S. dollar conversion resulted in the Company recording a net pre-tax loss of $1.3 million U.S. dollars in its condensed consolidated statement of income for the three months ended March 31, 2011.

As of March 31, 2011, Herbalife Venezuela s net monetary Bolivar denominated assets and liabilities was approximately $9.0 million, and included approximately $13.1 million in Bolivar denominated cash and cash equivalents and approximately $4.8 million in U.S. dollar denominated cash. The majority of these Bolivar denominated assets and liabilities were remeasured at the SITME rate. Although Venezuela is an important market in the Company s South and Central America Region, Herbalife Venezuela s net sales represented less than 2% of the Company s consolidated net sales for both the three months ended March 31, 2011 and 2010 and its total assets represented less than 3% of the Company s consolidated total assets as of both March 31, 2011 and December 31, 2010.

See the Company s 2010 10-K for further information on Herbalife Venezuela and Venezuela s high inflationary economy.

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3. Long-Term Debt

Long-term debt consists of the following:

	March 31, 2011	December 31, 2010
	(In millions)	
Borrowings under the prior senior secured credit facility	$	$ 174.9
Borrowings under the new senior secured revolving credit facility	180.0	
Capital leases	2.6	2.9
Other debt	0.3	0.3
Total	182.9	178.1
Less: current portion	1.7	3.1
Long-term portion	$ 181.2	$ 175.0

Interest expense was $3.3 million and $2.4 million for the three months ended March 31, 2011 and 2010, respectively. Interest expense for the three months ended March 31, 2011 included a $0.9 million write off of unamortized deferred financing costs resulting from the extinguishment of the prior senior secured facility as discussed below.

On March 9, 2011, the Company entered into a $700.0 million senior secured revolving credit facility, or the New Credit Facility, with a syndicate of financial institutions as lenders and terminated its prior senior secured credit facility, or the Prior Credit Facility, that consisted of a term loan and a revolving credit facility. The New Credit Facility has a five year maturity and expires on March 9, 2016. During March 2011, U.S. dollar borrowings under the New Credit Facility incurred interest at the base rate plus a margin of 0.75% or LIBOR plus a margin of 1.75%. After March 2011, based on the Company s consolidated leverage ratio, U.S. dollar borrowings under the New Credit Facility will bear interest at either LIBOR plus the applicable margin between 1.50% and 2.50% or the base rate plus the applicable margin between 0.50% and 1.50%. The Company, based on its consolidated leverage ratio, will pay a commitment fee between 0.25% and 0.50% per annum on the unused portion of the New Credit Facility. The New Credit Facility also permits the Company to borrow limited amounts in Mexican Peso and Euro currencies based on variable rates. The base rate under the New Credit Facility represents the highest of the Federal Funds Rate plus 0.50%, one-month LIBOR plus 1.00%, and the prime rate offered by Bank of America.

In March 2011, the Company used $196.0 million in U.S. dollar borrowings under the New Credit Facility to repay all amounts outstanding under the Prior Credit Facility. The Company incurred approximately $5.5 million of debt issuance costs in connection with the New Credit Facility. These debt issuance costs were recorded as deferred financing costs on the Company s condensed consolidated balance sheet and are being amortized over the term of the New Credit Facility. On March 31, 2011 and December 31, 2010, the weighted average interest rate for borrowings under the New Credit Facility and the Prior Credit Facility was 1.99% and 1.75%, respectively.

The New Credit Facility requires the Company to comply with a leverage ratio and an interest coverage ratio. In addition, the New Credit Facility contains customary covenants, including covenants that limit or restrict the Company s ability to incur liens, incur indebtedness, make investments, dispose of assets, make certain restricted payments, pay dividends, merge or consolidate and enter into certain transactions with affiliates. As of March 31, 2011, the Company was compliant with its debt covenants.

During the three months ended March 31, 2011, the Company borrowed $235.7 million and $54.0 million under the New Credit Facility and Prior Credit Facility, respectively, and paid a total of $55.7 million and $228.9 million of the New Credit Facility and Prior Credit Facility, respectively. As of March 31, 2011, the U.S. dollar amount outstanding under the New Credit Facility was $180.0 million. As of December 31, 2010, the amounts outstanding under the Prior Credit Facility, consisting of a term loan and revolving facility, were $143.9 million and $31.0 million, respectively. There were no outstanding foreign currency borrowings as of March 31, 2011 under the New Credit Facility.

4. Contingencies

The Company is from time to time engaged in routine litigation. The Company regularly reviews all pending litigation matters in which it is involved and establishes reserves deemed appropriate by management for these litigation matters when a probable loss estimate can be made.

As a marketer of dietary and nutritional supplements and other products that are ingested by consumers or applied to their bodies, the Company has been and is currently subjected to various product liability claims. The effects of these claims to date have not been material to the Company, and the reasonably possible range of exposure on currently existing claims is not material to the Company. The Company believes that it has meritorious defenses to the allegations contained in the lawsuits. The Company currently maintains product liability insurance with an annual deductible of $10 million.

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On April 16, 2007, Herbalife International of America, Inc. filed a Complaint in the United States District Court for the Central District of California against certain former Herbalife distributors who had left the Company to join a competitor. The Complaint alleged breach of contract, misappropriation of trade secrets, intentional interference with prospective economic advantage, intentional interference with contract, unfair competition, constructive trust and fraud and seeks monetary damages, attorney s fees and injunctive relief (*Herbalife International of America, Inc. v. Robert E. Ford, et al*). The court entered a Preliminary Injunction against the defendants enjoining them from further use and/or misappropriation of the Company s trade secrets on December 11, 2007. Defendants appealed the court s entry of the Preliminary Injunction to the U.S. Court of Appeals for the Ninth Circuit. That court affirmed, in relevant part, the Preliminary Injunction. On December 3, 2007, the defendants filed a counterclaim alleging that the Company had engaged in unfair and deceptive business practices, intentional and negligent interference with prospective economic advantage, false advertising and that the Company was an endless chain scheme in violation of California law and seeking restitution, contract rescission and an injunction. Both sides engaged in discovery and filed cross motions for Summary Judgment. On August 25, 2009, the court granted partial summary judgment for Herbalife on all of defendants claims except the claim that the Company is an endless chain scheme which under applicable law is a question of fact that can only be determined at trial. The court denied defendants motion for Summary Judgment on Herbalife s claims for misappropriation of trade secrets and breach of contract. On May 5, 2010, the District Court granted summary judgment for Herbalife on defendants endless chain-scheme counterclaim. Herbalife voluntarily dismissed its remaining claims, and on May 14, 2010, the District Court issued a final judgment dismissing all of the parties claims. On June 10, 2010 the defendants appealed from that judgment and on June 21, 2010, Herbalife cross-appealed. The parties have reached a settlement of the case which they are in the process of documenting. Herbalife will incur no financial liability in this settlement.

Certain of the Company s subsidiaries have been subject to tax audits by governmental authorities in their respective countries. In certain of these tax audits, governmental authorities are proposing that significant amounts of additional taxes and related interest and penalties are due. The Company and its tax advisors believe that there are substantial defenses to their allegations that additional taxes are owed, and the Company is vigorously contesting the additional proposed taxes and related charges. On May 7, 2010, the Company received an administrative assessment from the Mexican Tax Administration Service in an amount equivalent to approximately $96 million, translated at the period ended spot rate, for various items, the majority of which was Value Added Tax allegedly owed on certain of the Company s products imported into Mexico during the years 2005 and 2006. This assessment is subject to interest and inflationary adjustments. On July 8, 2010, the Company initiated a formal administrative appeal process. In connection with the appeal of the assessment, the Company may be required to post bonds for some or all of the assessed amount. Therefore, in July 2010, the Company entered into agreements with certain insurance companies to allow for the potential issuance of surety bonds in support of its appeal of the assessment. Such surety bonds, if issued, would not affect the availability of the Company s New Credit Facility. The Company did not record a provision as the Company, based on analysis and guidance from its advisors, does not believe a loss is probable. Further, the Company is currently unable to reasonably estimate a possible loss or range of loss that could result from an unfavorable outcome in respect to this assessment or any additional assessments that may be issued for these or other periods. The Company believes that it has meritorious defenses and is vigorously pursuing the appeal, but final resolution of this matter could take several years.

These matters may take several years to resolve. While the Company believes it has meritorious defenses, it cannot be sure of their ultimate resolution. Although the Company has reserved amounts for certain matters that the Company believes represent the most likely outcome of the resolution of these related disputes, if the Company is incorrect in the assessment, the Company may have to record additional expenses, when it becomes probable that an increased potential liability is warranted.

5. Comprehensive Income

Total comprehensive income consisted of the following:

	Three Months Ended	
	March 31,	**March 31,**

	2011	2010
	(In millions)	
Net income	$ 87.6	$ 51.9
Unrealized gain on derivative instruments, net of taxes	0.3	2.1
Foreign currency translation adjustment	14.9	(5.2)
Comprehensive income	$ 102.8	$ 48.8

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6. Segment Information

The Company is a network marketing company that sells a wide range of weight management products, nutritional supplements and personal care products within one industry segment as defined under the Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC Topic 280, *Segment Reporting*. The Company s products are manufactured by third party providers and by the Company in its Suzhou, China facility and in its manufacturing facility located in Lake Forest, California, and then are sold to independent distributors who sell Herbalife products to retail consumers or other distributors. Revenues reflect sales of products to distributors based on the distributors geographic location.

As of March 31, 2011, the Company sold products in 75 countries throughout the world and is organized and managed by geographic regions. The Company aggregates its operating segments, excluding China, into one reporting segment, or the Primary Reporting Segment, as management believes that the Company s operating segments have similar operating characteristics and similar long term operating performance. In making this determination, management believes that the operating segments are similar in the nature of the products sold, the product acquisition process, the types of customers to whom products are sold, the methods used to distribute the products, and the nature of the regulatory environment. China has been identified as a separate reporting segment as it does not meet the criteria for aggregation. The operating information for the Primary Reporting Segment and China, and sales by product line are as follows:

	Three Months Ended	
	March 31, 2011	**March 31, 2010**
	(in millions)	
Net Sales:		
Primary Reporting Segment		
United States	$ 162.2	$ 146.7
Mexico	103.9	71.8
Others	483.3	367.7
Total Primary Reporting Segment	749.4	586.2
China	45.7	32.4
Total Net Sales	$ 795.1	$ 618.6
Operating Margin(1)(2):		
Primary Reporting Segment		
United States	$ 68.4	$ 65.1
Mexico	40.4	24.9
Others	218.8	151.1
Total Primary Reporting Segment	327.6	241.1
China (3)	40.3	29.7
Total Operating Margin	$ 367.9	$ 270.8
Selling, general and administrative expenses	244.5	206.9
Interest expense, net	2.6	1.9
Income before income taxes	120.8	62.0
Income taxes	33.2	10.1

Net Income	$	87.6	$	51.9

	Three Months Ended			
	March 31, 2011		March 31, 2010	
	(in millions)			
Net sales by product line:				
Weight Management	$	498.6	$	387.2
Targeted Nutrition		180.2		138.6
Energy, Sports and Fitness		35.5		25.8
Outer Nutrition		36.6		31.0
Literature, promotional and other(4)		44.2		36.0
Total Net Sales	$	795.1	$	618.6
Net sales by geographic region:				
North America(5)	$	167.0	$	151.3
Mexico		103.9		71.8
South and Central America		125.3		91.3
EMEA(6)		153.9		130.8
Asia Pacific(7)		199.3		141.0
China		45.7		32.4
Total Net Sales	$	795.1	$	618.6

(1) Operating margin consists of net sales less cost of sales and royalty overrides.

(2) In the third quarter of 2010, the Company changed its method of allocation for certain costs to its business segments. Historical information presented has been reclassified to conform to the current presentation. This change had no effect on the Company s consolidated statements of income.

(3) Compensation to China sales employees and service fees to China licensed business providers totaling $21.8 million and $16.2 million for the three months ended March 31, 2011 and 2010, respectively, is included in selling, general and administrative expenses while distributor compensation for all other countries is included in royalty overrides.

(4) Product buybacks and returns in all product categories are included in the literature, promotional and other category.

(5) Consists of the U.S., Canada and Jamaica.

(6) Consists of Europe, Middle East and Africa.

(7) Consists of Asia (excluding China), New Zealand and Australia.

As of March 31, 2011 and December 31, 2010, total assets for the Company s Primary Reporting Segment were $1,287.7 million and $1,162.1 million, respectively. As of March 31, 2011 and December 31, 2010, total assets for the China segment were $70.3 million and $70.1 million, respectively.

7. Share-Based Compensation

The Company has share-based compensation plans, which are more fully described in Note 9, *Share-based Compensation*, to the Consolidated Financial Statements in the 2010 10-K. During the three months ended March 31, 2011, the Company granted stock awards subject to continued service, consisting of stock units and stock appreciation rights, with vesting terms fully described in the 2010 10-K.

For the three months ended March 31, 2011 and 2010, share-based compensation expense amounted to $5.6 million and $5.3 million, respectively. As of March 31, 2011, the total unrecognized compensation cost related to all non-vested stock awards was $25.6 million and the related weighted-average period over which it is expected to be recognized is approximately 1.5 years.

The following tables summarize the activity under all share-based compensation plans for the three months ended March 31, 2011:

Stock Options & Stock Appreciation Rights	**Awards (In thousands)**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term**	**Aggregate Intrinsic Value (In millions)**
Outstanding at December 31, 2010	6,390	$ 28.75	5.7 years	$ 253.1
Granted	20	$ 73.73		
Exercised	(334)	$ 26.22		
Forfeited	(34)	$ 32.80		